STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC

Materials for Staff Presentation to the Federal Open Market Committee

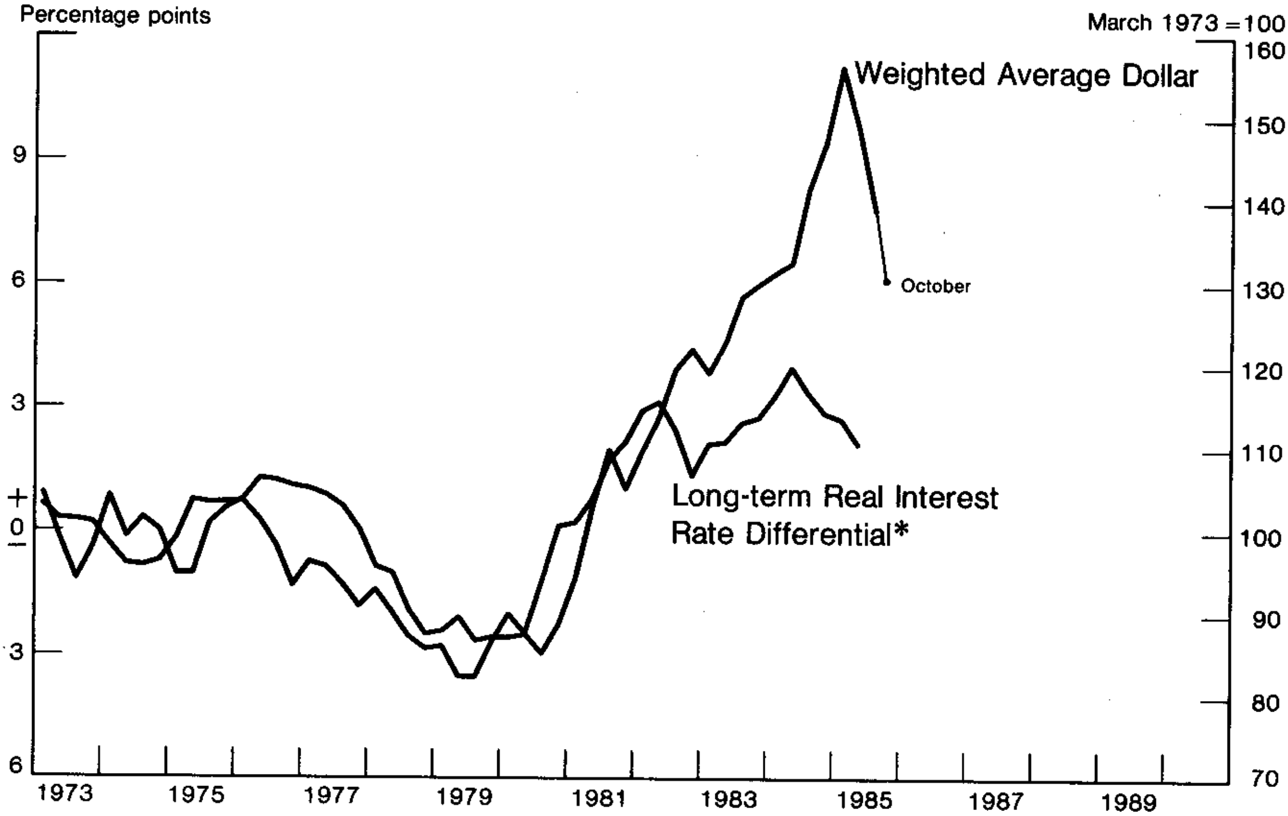
Economic and Policy Implications of Exchange Rate Adjustments

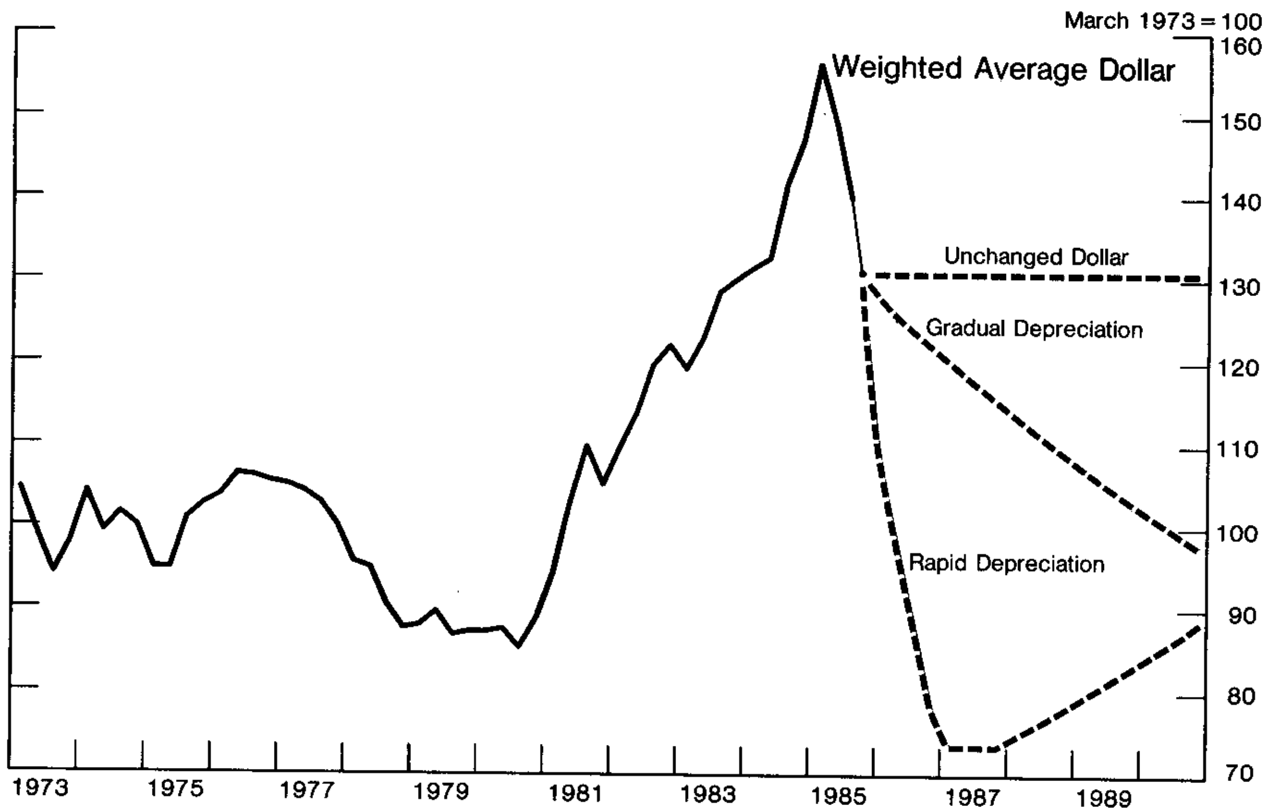
November 4, 1985

Exhibit 1

Foreign Exchange Value of the U.S. Dollar

Quarterly





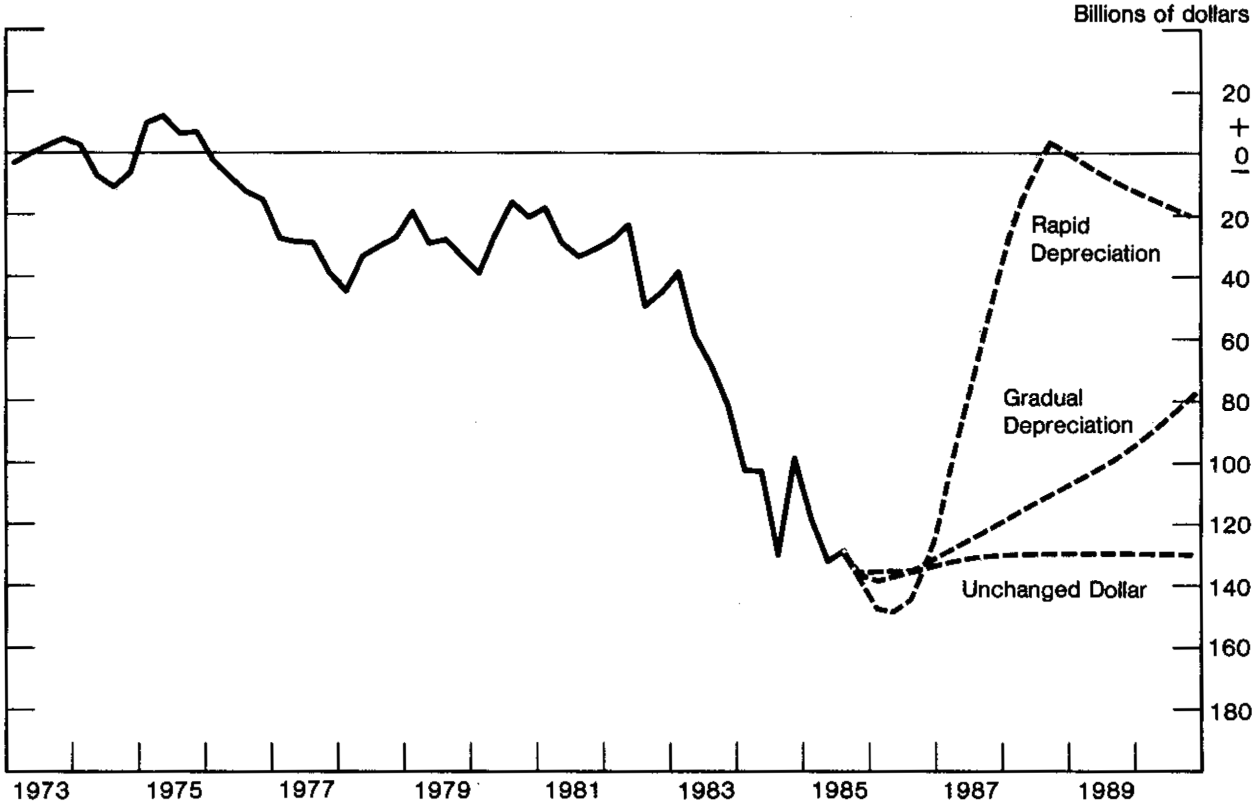
*Difference between long-term government bond yields of the U.S. and a weighted average of other G-10 countries plus Switzerland, minus the difference between 12-quarter centered U.S. and foreign inflation rates at annual rates.

Exhibit 2

U.S. External Balances

Quarterly

Merchandise Trade Balance



Current Account Balance

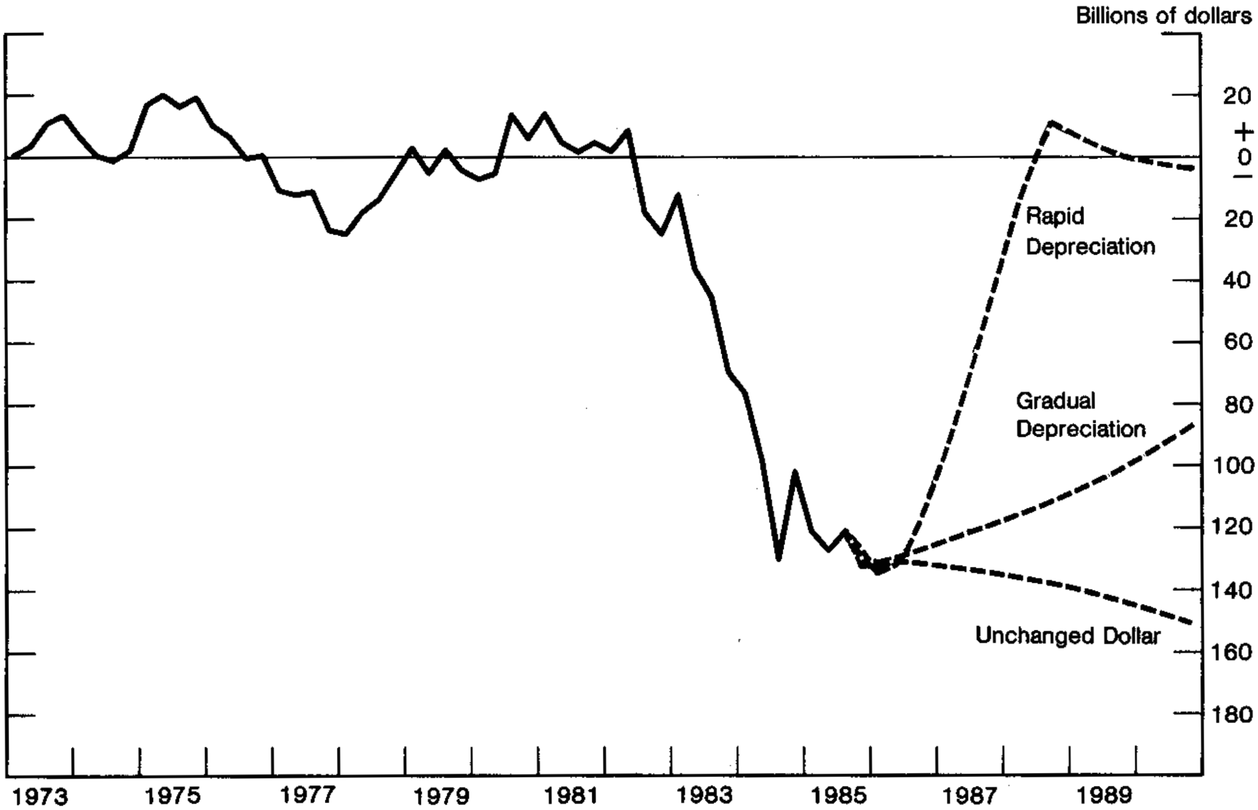


Exhibit 3

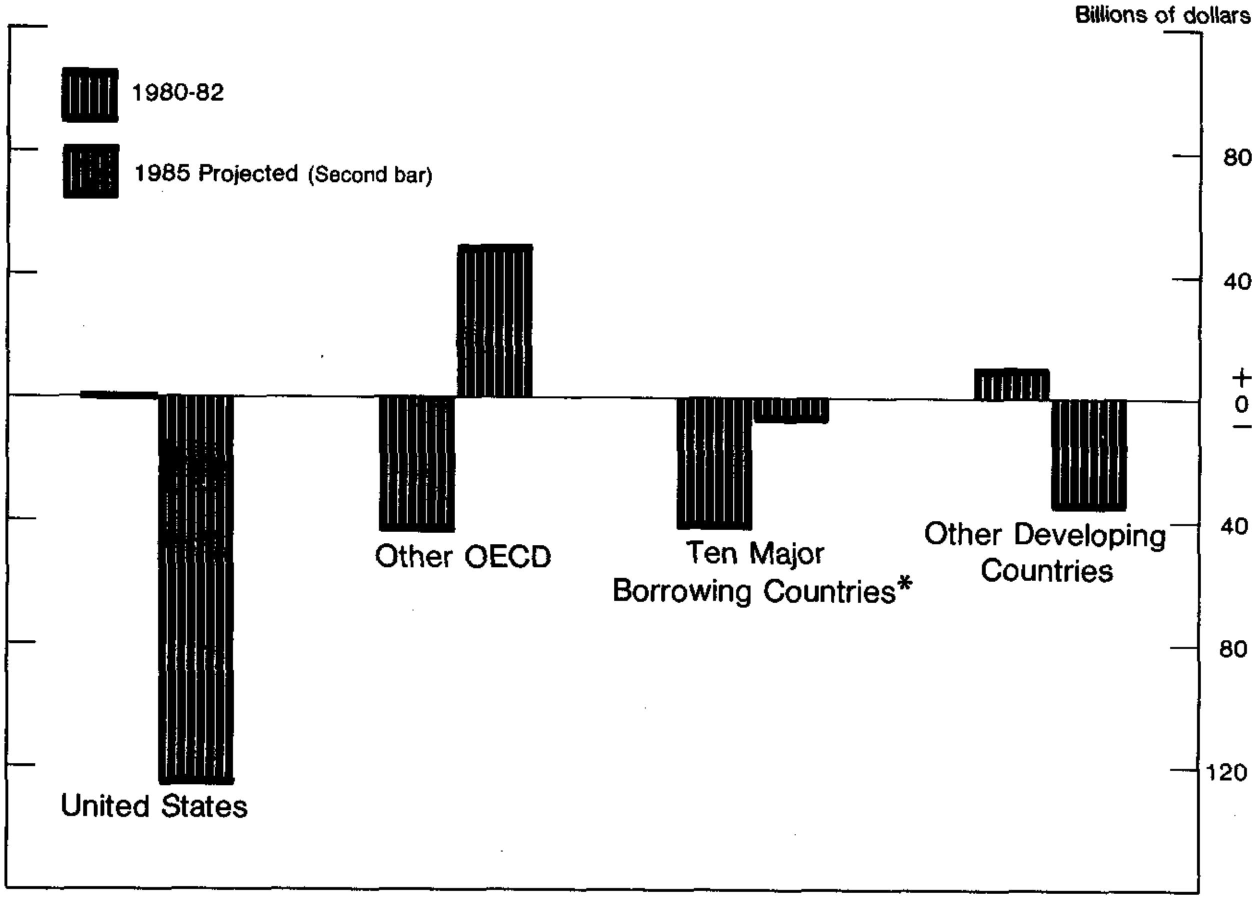
U.S. Net International Investment Position

End of Year

	Billions of Dollars	Percent of GNP
1950	13	4.5
1960	45	8.9
1970	58	5.8
1980	106	4.0
1984	28	0.1
1985	–63	–1.6
1990:		
With Unchanged Dollar	–700	–13.0
With Gradual Depreciation	–550	–10.0
With Rapid Depreciation	–200	–3.5

Exhibit 4

Global Current Account Balances



	Billions of Dollars
Impact of one percentage point higher dollar interest rates on the net interest payments of:	
All developing countries, of which:	3
Ten major borrowing countries*	2½
OPEC	– ¾

* Includes Argentina, Brazil, Chile, Colombia, Korea, Mexico, Nigeria, Peru, Philippines, and Venezuela.

Exhibit 5

Current Account Balances of Major Industrial Countries

1985 Projected

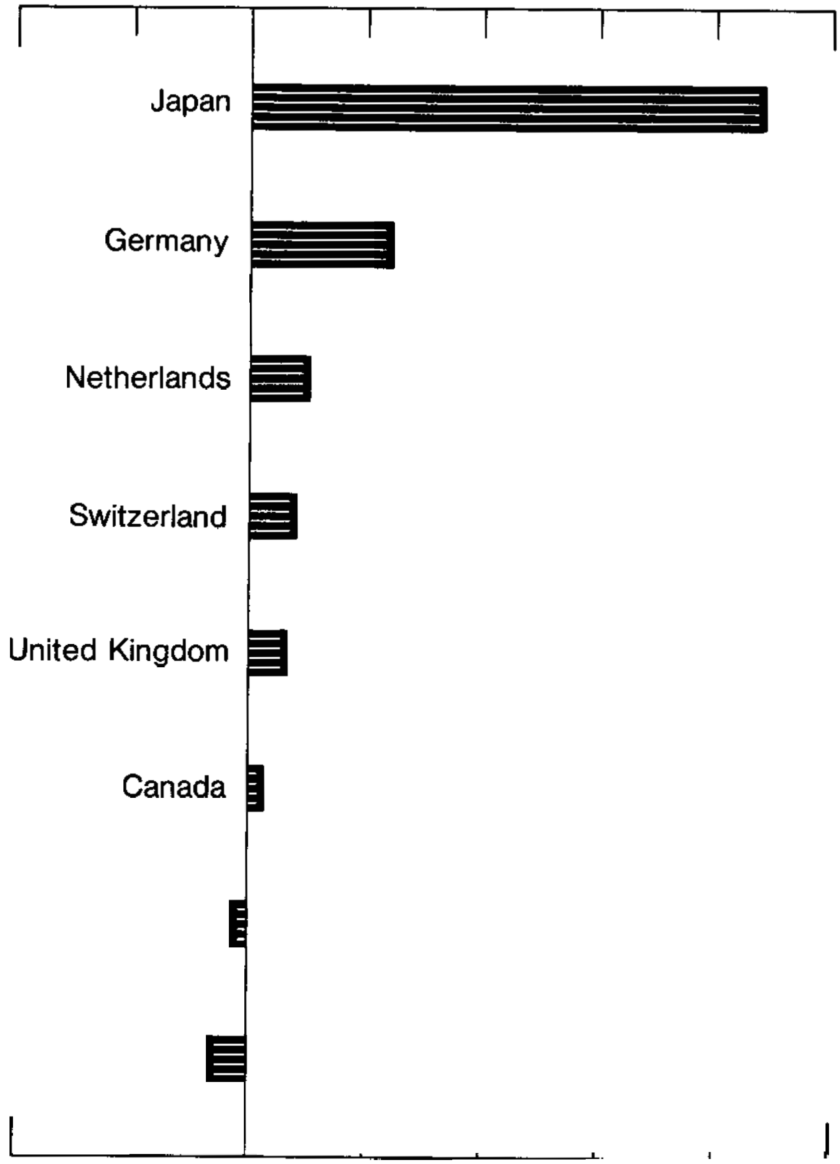
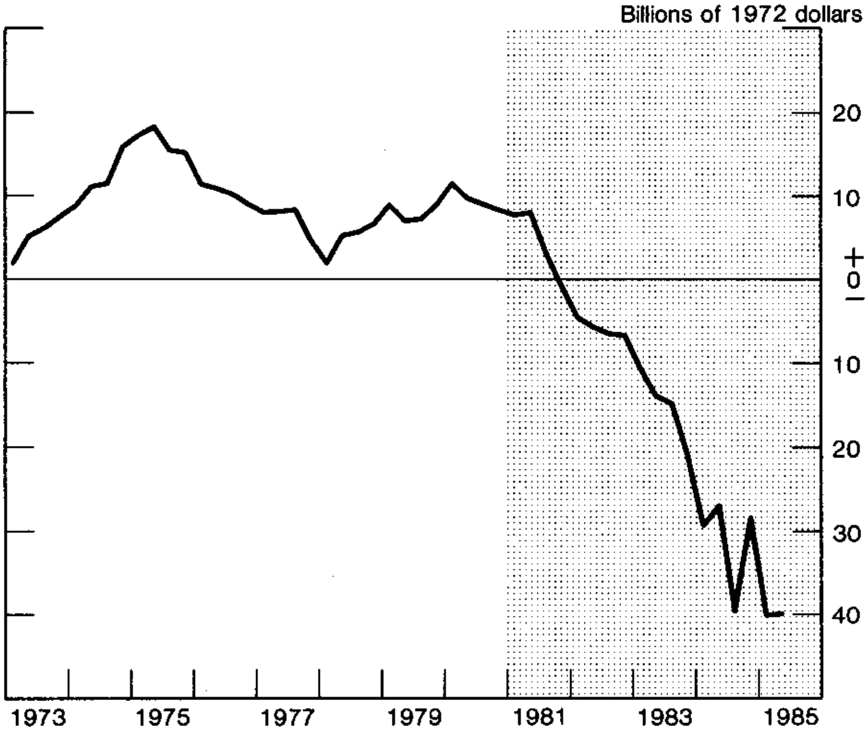


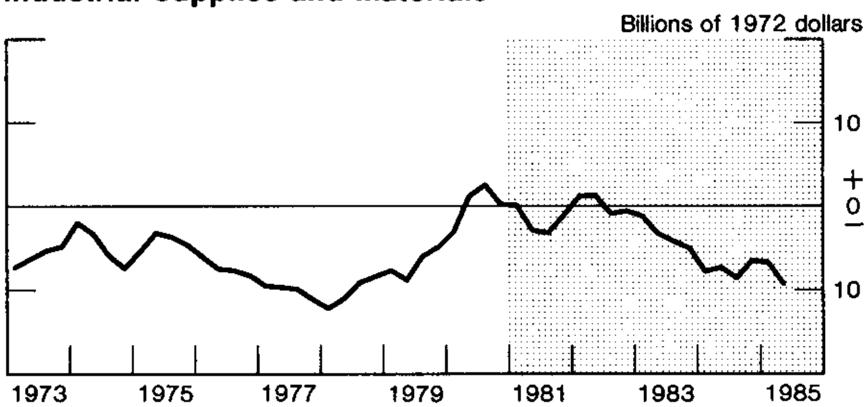
Exhibit 6

U.S. Real Net Exports by Sector

Finished Manufactures



Industrial Supplies and Materials



Food and Agricultural Products

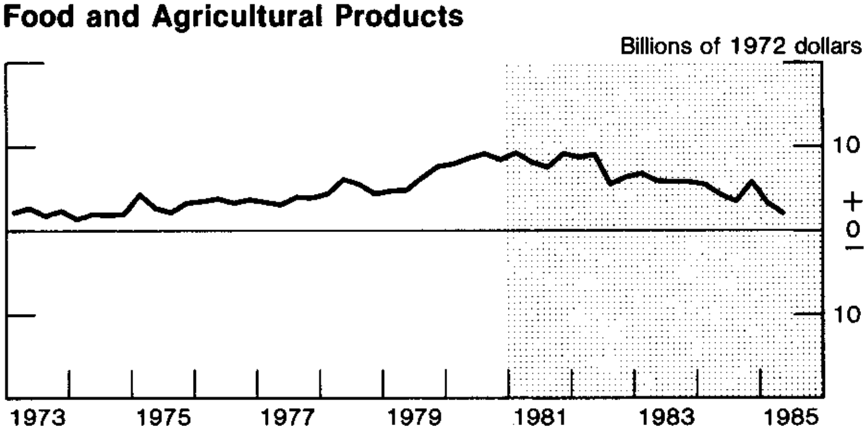


Exhibit 7

Composition of Current Real GNP and Hypothetical Real GNP Scaled to 1985 Magnitudes

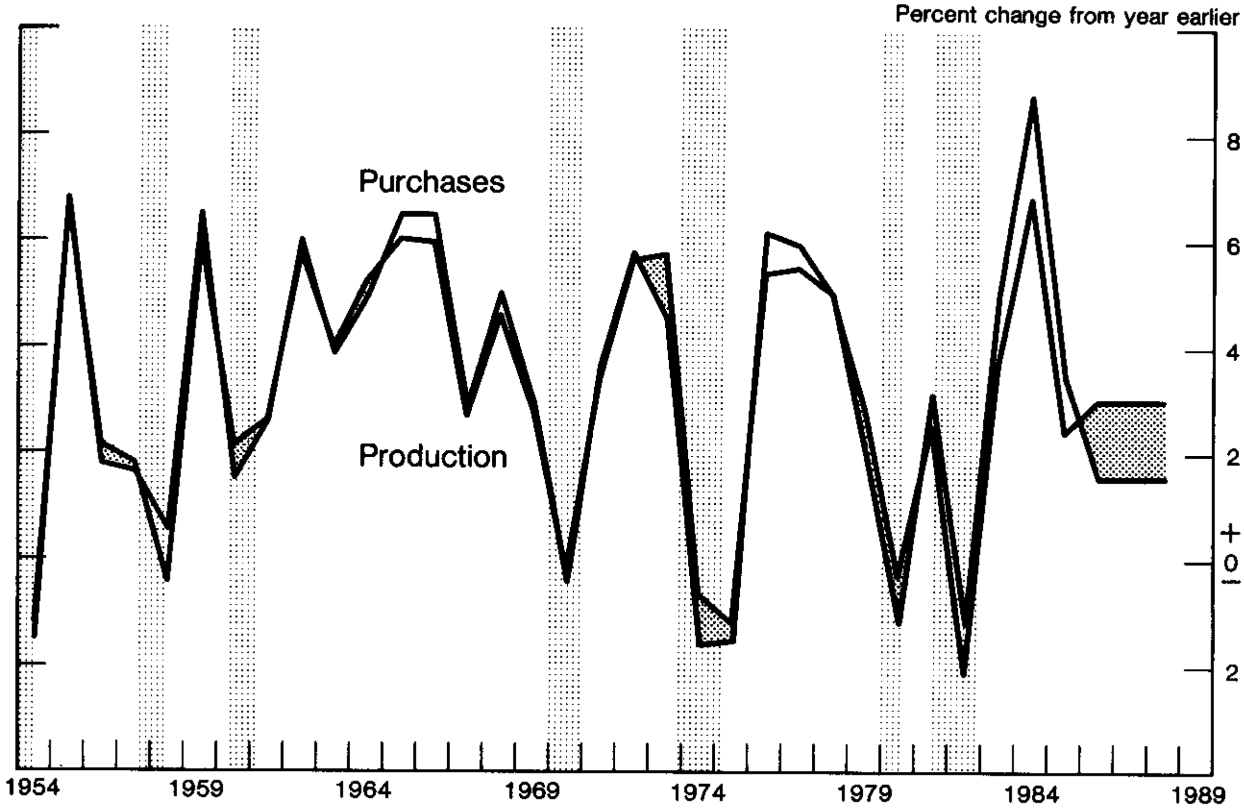
Billions of 1972 Dollars

	Staff Estimate[1] 1985 (1)	Hypo-thetical Example (2)	Percentage Change (3)
1. Gross national product (C + I + G + X − M)	1679	1679	0
2. Gross domestic purchases (C + I + G)	1711	1634	− 4½
3. Gross private domestic purchases (C + I)	1392	1315	− 5½
4. Net exports (X − M)	− 33	44	

1. Staff estimate for 1985 in 1972 dollars (October Greenbook).

Exhibit 8

Real GNP and Gross Domestic Purchases



Manufacturing Capacity Utilization Rate

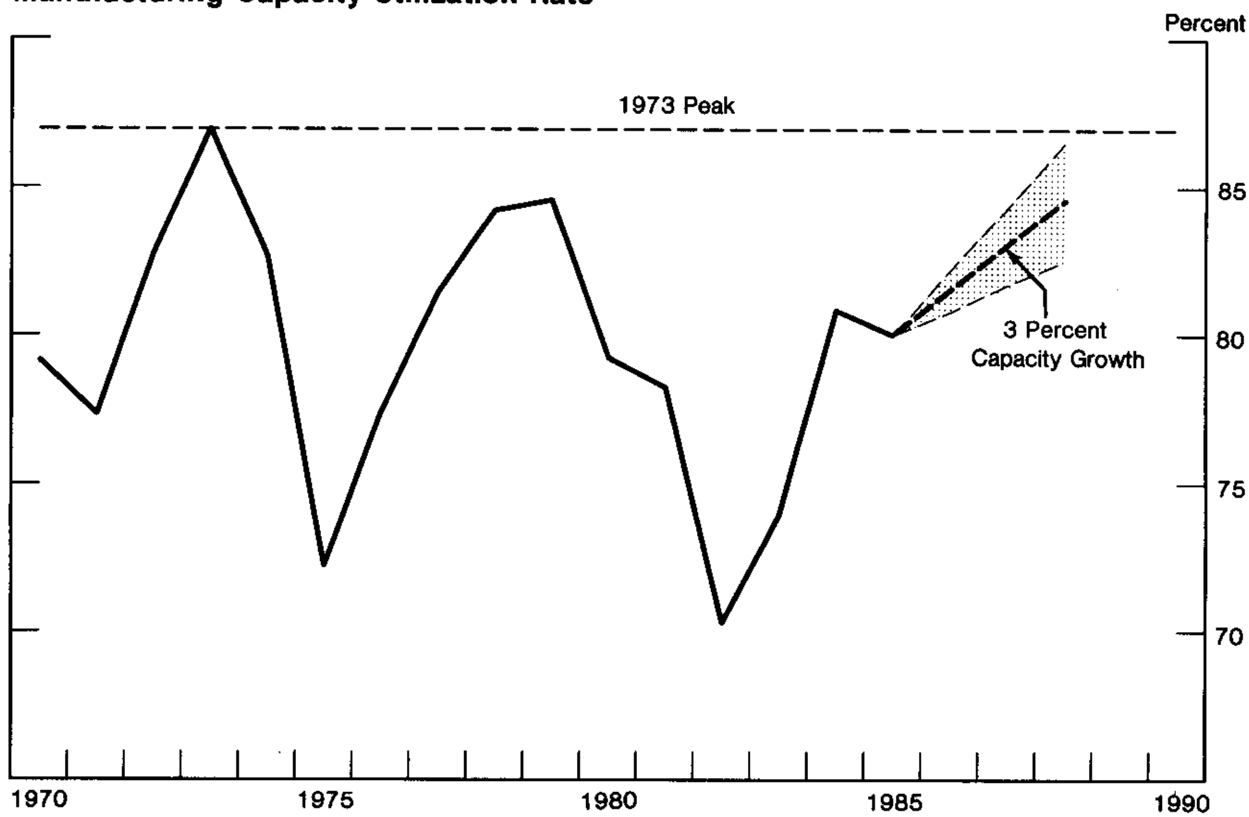


Exhibit 9

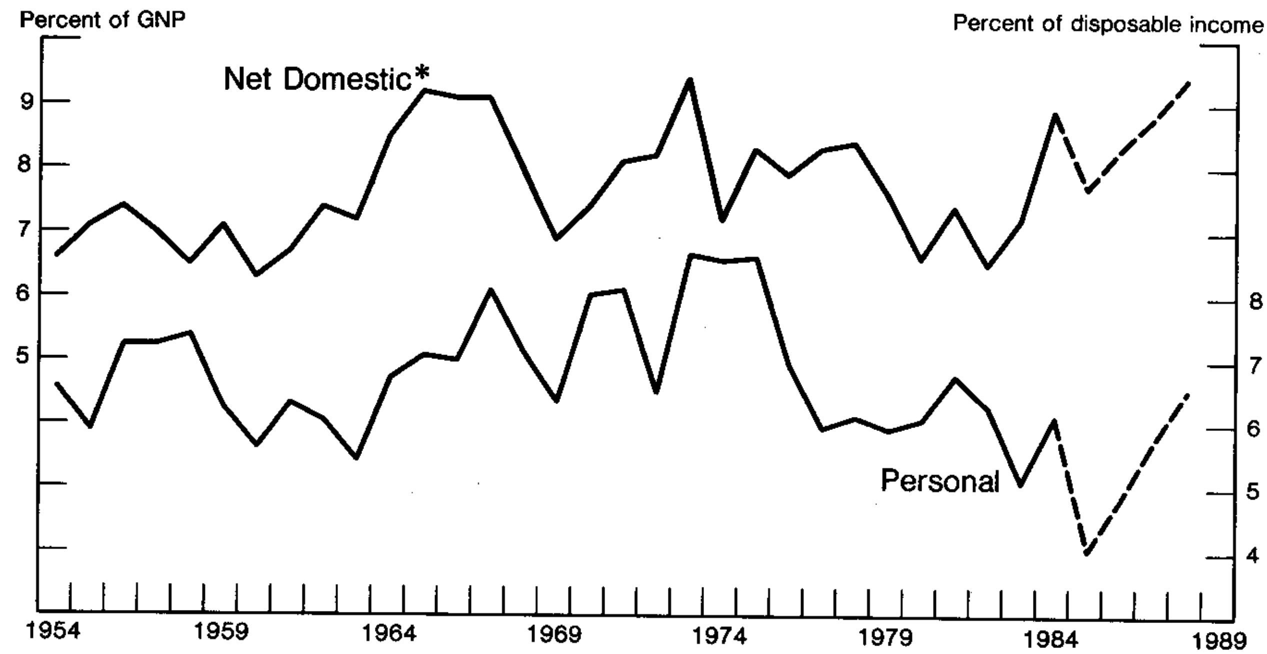
Demands on and Sources of Net Saving

Billions of Current Dollars

	Staff Estimate[1] 1985 (1)	Hypothetical Example (2)
Demands on net saving		
1. Net private investment	223	169
2. Federal budget deficit	194	194
Sources of net saving		
3. Net domestic nonfederal saving	298	363
4. Net foreign investment	119	0
Memo:		
5. Personal saving rate	4	6½

1. Staff estimate for 1985 in current dollars (October Greenbook).

Personal Saving and Net Domestic Saving



*Net domestic nonfederal saving.

Exhibit 10

Assumed Paths of Key Variables with a Gradual Depreciation

Percent Change; Fourth Quarter to Fourth Quarter

	1985	1986	1987	1988	1989	1990
1. Real GNP	2.0	2.4	2.7	2.7	2.7	2.7
2. Domestic purchases (C + I + G)	3.2	1.9	1.9	2.2	2.3	2.5
3. GNP deflator	3.6	3.7	4.4	4.7	4.8	4.8
4. Treasury bill rate (level in Q4)	7.2	6.5	6.8	7.0	7.0	7.0

Key assumptions

Monetary policy: Constant money growth rate (abstracting from shifts in money demand)

Fiscal policy: Narrowing of the structural deficit consistent with the objectives of the Congressional budget resolution

Exchange rate: 5 percent per year depreciation, 1986 – 1990

Exhibit 11

Impact of a Rapid Depreciation

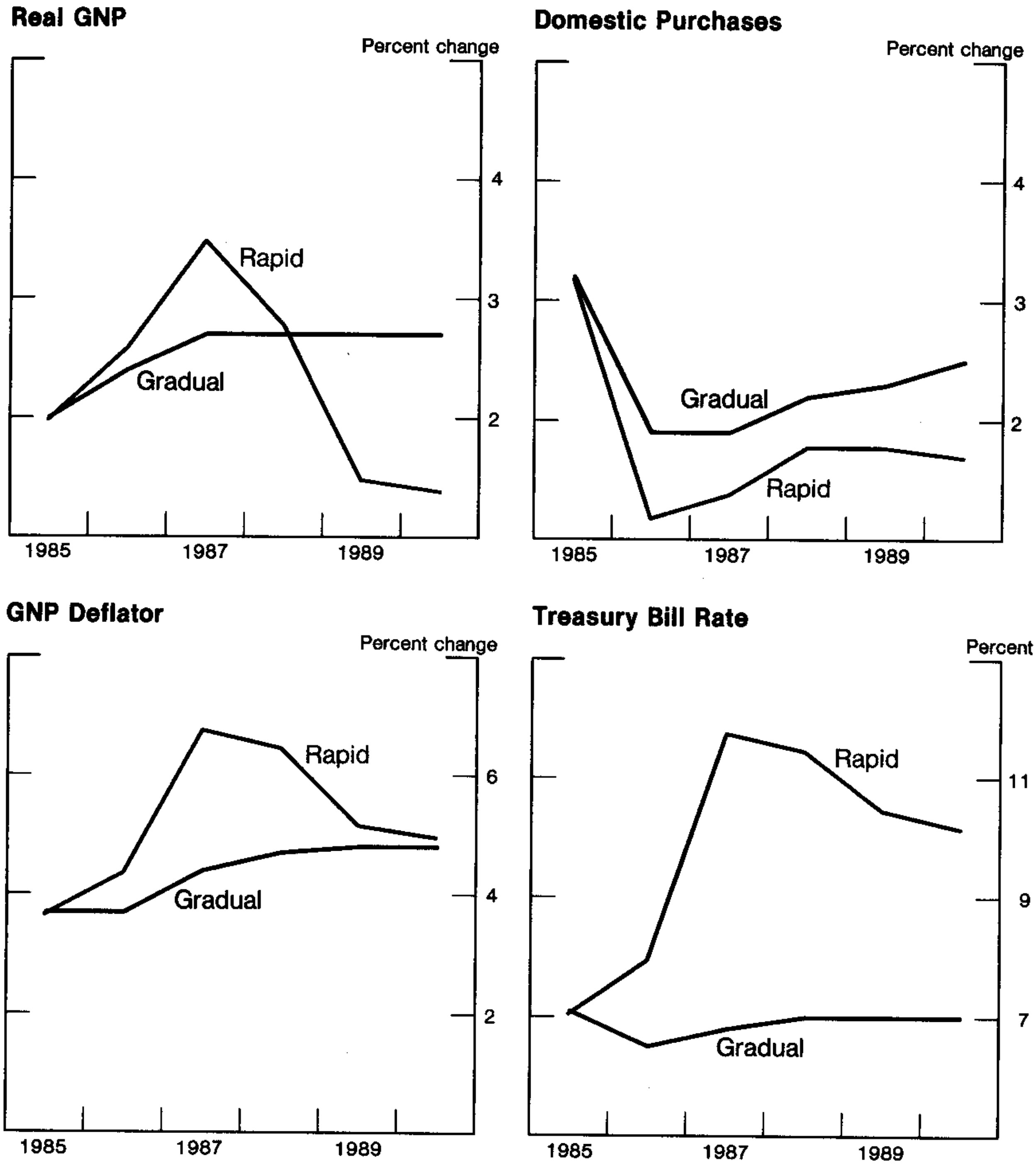


Exhibit 12

Impact of a Rapid Depreciation on Spending and Saving

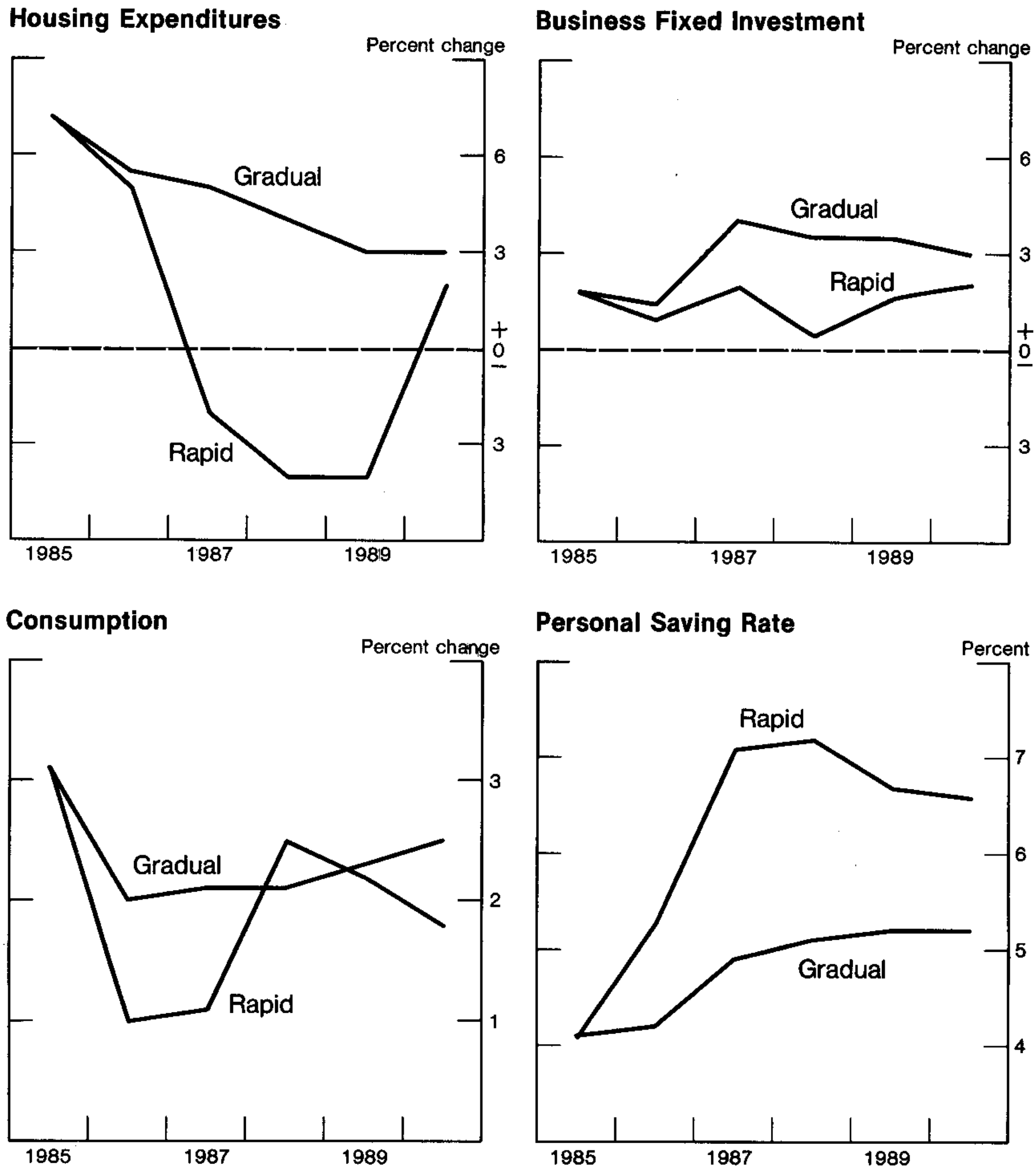


Exhibit 13

Risks to the Adjustment Process

- It may not be physically possible to reallocate sufficient resources to the traded goods sector.
  - Bottlenecks and capacity constraints
  - Labor market shortages
- Sharp increases in capacity utilization rates could occur if domestic demand were not crowded out sufficiently.
- Interest rate effects could be relatively strong because of the sensitive position of many depository institutions.
- Household borrowers also could be quite sensitive because of high debt burdens and low saving rate.
- Negative financial market effects could be strong enough to offset the positive trade effect associated with a decline in the dollar.